INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

Submission

on

Taxation (Tax Administration and Remedial Matters) Bill Supplementary Order Paper 220

29 April 2011

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1.0 Introduction

1.1 The Investment Savings and Insurance Association of NZ Inc. ("ISI") appreciates the opportunity to comment Supplementary Order Paper No.220 ("SOP220") amending the Taxation (Tax Administration and Remedial Matters) Bill.

1.2 ISI is the industry association representing the companies which issue or manage life insurance, superannuation and managed funds.

1.3 ISI has 23 members and 18 associate members who collectively manage over $60 billion in collective investments on behalf of 1.3 million New Zealanders. ISI members are also the leading providers of KiwiSaver funds and include the KiwiSaver default providers.

1.4 A list of members appears at the end of this submission.

1.5 ISI supports the change in legislation to facilitate international investors investing into NZ PIEs and we welcome the opportunity to submit on SOP220.

2.0 Summary

We recommend:

- Reduction of 1.4% Approved Issuer Levy ("AIL") on financial arrangements to zero percent
  - Alternatively, both realised and unrealised gains on financial arrangements should be treated as foreign sourced income and taxed at the nil rate, or
  - AIL should only be applied to the interest on the financial arrangement that would have been subject to withholding tax if paid to a non resident
- Removal of the requirement to pass dividends on to investors within 2 business days
- Confirmation of treatment of listed PIEs holding property investments.
- Extension of the de minimis rules to PIE attributed income for variable investor rate foreign investment PIEs where they receive income from foreign investment PIEs receiving only foreign income.

3.0 Discussion

3.1 ISI has participated in consultation with officials since the release of the April 2010 issues paper: *Allowing a zero percent tax rate for non-residents investing in a PIE.*
IRD officials have been very supportive of industry comments and have developed legislation that broadly reflects the feedback provided by the industry.

3.2 However, there are some remaining areas where we consider that the legislation could be improved and these are the areas in which we recommend changes to SOP220.

3.3 **Income from Financial Arrangements – Proxy for Approved Issuer Levy ("AIL")**
Under the proposed legislation, income from New Zealand financial arrangements will be subject to tax at a rate of 1.44% (referred to hereafter as the 'AIL rate').

However, we recommend that clause 24C which inserts new clause 40B should be amended to reduce the prescribed rate in row 4 of Table 1B from 1.44% to zero. We consider that a reduction in the AIL rate to zero percent would be appropriate in anticipation of proposed

legislation to exempt AIL from certain widely held bonds. By default most PIEs would meet the widely held definition and therefore, we consider that reducing the AIL rate to 0% would be consistent with the pending AIL legislation in relation to widely held securities.

Any lost revenue would be minimal and would be unlikely to exceed the compliance cost of maintaining both another PIR rate as well as tracking another type of taxable income.

3.4 Financial Arrangements - Tax on Market Movements

If the recommendation to reduce the AIL rate to zero percent is not accepted, we recommend that the AIL only be applied to the interest on the financial arrangement that would have been subject to withholding tax if paid to a non resident. Both realised and unrealised gains on financial arrangements should be treated as foreign sourced income and taxed at the nil rate. This would ensure that the foreign investor in a foreign investment PIE is taxed on only the interest receipts/coupon payments. It would also align the treatment with the position where the foreign investor had invested directly in the underlying financial arrangement and be consistent with the policy underlying these reforms being that the NZ tax impost should mirror the position as if the investor had directly invested.

As the legislation is currently written, in any given financial year foreign investors are taxed on interest and they are also taxed on any movement in market value under the financial arrangement rules due to most funds adopting an IFRS method.

Further new section DB54B denies a foreign investment PIE a deduction for any expenditure incurred by the PIE in deriving income and new section HM35C treats any loss and any expense as zero for the purposes of section HM36 in the calculation of an amount attributed to a notified foreign investor.

We believe that, in the event that a loss in one period is recovered by a gain in the next, investors are likely to be surprised if they are taxed on that recovery but are not allowed a deduction for the loss they may have incurred. In order to reduce the chance of foreign investor being penalised for large market value movements around balance date we recommend that both realised and unrealised gains on financial arrangements should be treated as foreign sourced income and taxed at the nil rate.

Alternatively, if there are important design implications for taxing market movements, the impact to foreign investors could be reduced by taxing only the realised movements (which are already separately tracked for financial reporting purposes). This could be achieved by deeming a foreign investment PIE to be a cash basis person for the purposes of the financial arrangement rules or allowing funds to select a spreading method under the financial arrangement rules whereby unrealised movements are not treated as taxable income.

3.5 Determining Amounts for Foreign Investors

Clause 16E inserts new provisions for the calculation of the daily taxable income, and for foreign investors resets daily losses to nil. As noted above foreign investors are taxed under the financial arrangement rules. This provision ensures any daily realised or unrealised losses are unable to be carried forward or taken into account in the calculation of the taxable attributed income for the year. Effectively this means that foreign investors will be taxed on all gains in value over the year but no account is taken of any declines in value or losses during the year. This treatment is likely to be unintended and we do not believe this is an appropriate tax policy outcome. In fact, it would represent a significant difference between the tax treatment of a PIE and a direct investment and would be a significant issue

for a PIE with NZ financial arrangements that is considering adopting the new rules for foreign investors. It may also act as a significant barrier to foreign investors wishing to invest via foreign investment PIEs.

At a minimum, changes need to be made to enable tax losses arising from net market movements to be carried forward within a single tax year to ensure that foreign investors are taxed only on the net gains from financial arrangements within a tax year.

3.6 **NRWT Calculation Method**

In order to withheld NRWT from dividends received by foreign investment PIEs, the proposed bill requires that such dividends are paid to non resident investors within 2 days of receipt.

We question why there is a requirement to pass dividends on to investors within 2 business days. Funds have no control over when dividends are received, and the requirement to pass on the dividends as soon as they are received may impose significant compliance costs on some funds.

As no NRWT credit can be obtained by foreign investors unless the dividend is passed on by the foreign investment PIE, we do not believe that a specific time period is required. In particular, if a foreign investment PIE has significant foreign investors that require a NRWT credit, we expect that the commercial arrangements between the fund and its investors will result in dividends received being paid to foreign investors in a timely fashion

If a time period is considered necessary, we recommend that payment should be made to foreign investors within 20 days of the end of the tax year in which the income was received by the foreign investment PIE.

3.7 **Property Investments**

Clause 18H of the SOP modifies the entry rules for foreign investment PIEs. Effectively these provisions carve out direct investment in land and investment in a land investment company. However an investment in a “listed PIE” would appear not to be included in the exclusion as it is neither a direct investment nor a “land investment company”.

We consider that “listed PIEs” should not be an excluded investment class for a foreign investment PIE. This is due to income from land being taxed at the company tax rate (also being the top PIR rate) within a “listed PIE” and therefore no tax revenue would be lost from allowing foreign PIEs to hold this type of investment. An investment in a multi-rate PIE which itself has a direct investments in land or a land investment company, also does not seem to be covered by the carve-out in clause 18H of the SOP.

Please confirm whether this clause is meant to capture such multi-rate PIE investments or Listed PIEs.

3.8 PIE Attributed Income

As currently proposed in Clause 18H of the SOP, a foreign investment PIE otherwise deriving only foreign sourced income (a Zero Rate PIE) may apply a tax rate of 0% to PIE attributed income that meets certain conditions (the de minimis rule). The de minimis rule does not apply to a variable investor rate foreign investment PIE (a Variable Rate PIE).

Commonly, a Variable Rate PIE may invest into one or many Zero Rate PIEs. As currently proposed, the PIE attributed income derived by the Zero Rate PIE is treated as foreign income under the de minimis rule (where criteria met). However, PIE attributed income derived by the Variable Rate PIE will need to be separated into different income sources. This situation presents two issues:

1. A Zero Rate PIE is not required to provide a split of income by source and, as a result, the Variable Rate PIE will not be able to identify the income source and applicable tax rate on the PIE Attributed income that derives from a Zero rate PIE.

2. If the Variable Rate PIE does require the Zero Rate PIE to split income by source, the Zero Rate PIE will be required to upgrade systems and accounting to the same level as that required for a Variable Rate PIE, i.e. the benefits of the less complex Zero Rate PIE will be lost and the industry will suffer significantly increased compliance costs.

Fundamentally we consider that the best result would be that all PIE attributed income from a Zero Rate PIE should be considered to be foreign sourced income for a Variable Rate PIE. This would reduce significant compliance costs.

List of ISI Members

AIA NZ
AMP Financial Services/
AXA New Zealand
Asteron Life Ltd
BNZ Investments and Insurance
CIGNA Life Insurance NZ Ltd
Dorchester Life
Fidelity Life Assurance Co Ltd
FNZ
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
Kiwibank Ltd
Medical Assurance Society NZ Ltd
Mercer
Munich Reinsurance Co of Australasia Ltd
OnePath
Pinnacle Life
Public Trust
RGA Reinsurance Co. of Australia Ltd
Sovereign Ltd
Southsure Assurance
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac/ BT Funds Management Ltd

Associate Members
Bell Gully
BNP Paribas
Bravura Solutions
Burrowes & Co
Chapman Tripp
Davies Financial & Actuarial Ltd
Deloitte
DLA Phillips Fox
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Minter Ellison Rudd Watts
Morningstar Research Ltd
PricewaterhouseCoopers
Russell McVeagh
Simpson Grierson